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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 804

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BUSCH'S KREDIT JEWELRY CO., INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Second Circuit entered in the above-entitled case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 35) are not officially reported. The opinion of the court below (R. 43(a)-46) is reported at 179 F. 2d 298.

JURISDICTION

The judgment of the Court of Appeals was entered on January 6, 1950. (R. 46.) By order of Mr. Justice Jackson, dated March 24, 1950, the

time for filing a petition for a writ of certiorari was extended to and including May 7, 1950. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether in computing its excess profits tax credit, taxpayer, which filed its income tax returns on the installment basis under Section 44 (a) of the Internal Revenue Code, and which elected under Section 736 (a) to compute its excess profits net income on the accrual basis, may include its uncollected installment profits, which had not been subjected to income tax, in its "accumulated earnings and profits" under Section 718 (a) (4) of the Internal Revenue Code for the purpose of determining its equity invested capital under Section 718.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and relevant regulations are set forth in the Appendix, *infra,* pp. 18-25.

STATEMENT

This case involves a deficiency in excess profits taxes for the year 1944 and income tax for 1945. The facts, most of which have been stipulated (R. 27-31), are as follows:

Taxpayer, a New York corporation, is engaged in the retail sale of jewelry and related merchandise. Virtually all of its sales are made on installment credit. For income tax purposes, it reports income from installment sales upon the install-

ment basis as permitted by Section 44 (a) of the Internal Revenue Code. (R. 28.) In its 1942 excess profits tax return, taxpayer qualified for and elected to compute excess profits net income on the accrual basis as permitted by Section 736 (a) of the Code. In accordance with that section, taxpayer has computed its excess profits net income on such basis for all years from 1940 to 1945, inclusive. (R. 28.)

Taxpayer computed its excess profits tax credit on the invested capital basis. One element of invested capital under Code Section 718 is "accumulated earnings and profits". Taxpayer sought to include therein uncollected profits attributable to installment sales, although, since it has reported income under Section 44 (a) of the Code, none of the uncollected profits had been recognized in the computation of taxpayer's income tax liability; however, because taxpayer so elected under Section 736 (a) of the Code, it has accrued post-1940 installment income, thus subjecting such income to the excess profits tax.

In the Commissioner's computation of taxpayer's excess profits credits for the years 1941-1945, inclusive, no amount of uncollected profits on installment sales was included as a part of accumulated earnings and profits at the beginning of the respective years.[1] A portion of the uncollected

[1] The excess profits credits for the calendar years 1941-1943 are relevant to the determination of the adjusted excess profits net income for 1944 because of the provisions of Section 710 (b) (3) of the Code. (R. 29.)

profits on installment sales outstanding at the beginning of each of the years 1941 and 1942,[2] and the entire amount of the uncollected profits on installment sales outstanding at the beginning of each of the years 1943, 1944 and 1945, have been included in taxpayer's excess profits net income for those years, computed on the accrual basis in the following amounts (R. 29):

Year	*Amount*
1941	$446,126.91
1942	643,714.31
1943	333,717.31
1944	199,388.13
1945	227,205.50

The amount of taxpayer's accumulated earnings and profits as of December 31, 1939, exclusive of uncollected profits on installment accounts, was $245,134.31. Uncollected profits at that date were $554,985.85, of which $546,155.30 was subsequently realized through collections from 1940 through 1945. (R. 30.) None of these installment collections as they became realized profits were included or includible in the computation of taxpayer's excess profits net income for the years 1940 to 1945, inclusive, but were included in the computation of taxpayer's income subject to income tax for those years and are included in accumulated earnings and

[2] The portion of the uncollected profits for 1941 and 1942 which were excluded were those resulting from sales made prior to January 1, 1940, the period prior to the effective date of the excess profits tax law.

profits at the beginning of each year following the year of realization (R. 30), as shown in the table setting out the Commissioner's determination of taxpayer's invested capital as follows (R. 31):

Calendar Year	Money paid in for stock	Accumulated earnings and profits	Total
1941	$198,700.00	$250,569.77	$449,269.77
1942	198,700.00	295,691.96	494,391.96
1943	198,700.00	347,803.94	546,503.94
1944	198,700.00	413,543.01	612,243.01
1945	198,700.00	421,949.11	620,649.11

The Tax Court, following its decision in *J. L. Goodman Furniture Co.* v. *Commissioner,* 11 T. C. 530, approved the Commissioner's determination that the taxpayer could not increase the base of its excess profits tax credit by the amount of uncollected profits from installment sales which had not been included in the income subject to income tax although it had been included in excess profits tax net income. (R. 35.)

The Court of Appeals reversed the Tax Court and specifically rejected the Treasury Regulations which expressly provide that, regardless of the election under Section 736 (a), uncollected installment profits which have not been subjected to income tax are not includible in the accumulated earnings and profits (R. 43(a)-46).

REASONS FOR GRANTING THE WRIT

As in the cases of *John Breuner Co.* v. *Commissioner,* No. 805, and *Basalt Rock Co.* v. *Commissioner,* No. 803, in which petitions for writs of certiorari to the Ninth Circuit are simultaneously being filed, the Court of Appeals here has erron-

eously reversed the Tax Court on a question of general tax importance and of far-reaching administrative significance; and in so doing has struck down Treasury Regulations promulgated under the specific statutory authority of Congress and interpreting complicated provisions of the excess profits tax statute involving the interrelationship of income and excess profits taxation and the use of a dual system of accounting.

In *Breuner* and in the present case, the controversy, as in *Commissioner* v. *South Texas Co.*, 333 U. S. 496, is whether uncollected installment profits, which the taxpayer had elected under Section 44(a) of the Internal Revenue Code not to report as a part of its taxable income for the purpose of the income tax levied under Chapter 1 of the Code, may nevertheless be included in the taxpayer's "accumulated earnings and profits" which under Section 718(a)(4) (Appendix, *infra,* pp. 20-21) is one element of equity invested capital, itself a component of invested capital (Sections 715, 716, 717) which in turn forms one of the bases of the excess profits credit (Sections 712, 714). See *Commissioner* v. *South Texas Co., supra,* pp. 497-498. Unlike *South Texas,* however, the instant taxpayer availed itself of the election under Section 736(a) (Appendix, *infra,* pp. 21-23), permitting it "in accordance with regulations prescribed by the Commissioner" to compute its income from installment sales for excess profits

tax purposes on the accrual basis in lieu of the installment method utilized for income tax purposes. The Commissioner's regulations adopted pursuant to this express delegation of authority (Sec. 35.736(a)-2, Treasury Regulations 112, Appendix, *infra*, pp. 23-25) state that if the taxpayer uses the invested capital method of computing the excess profits credit "the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736(a) * * *." The Tax Court, adhering to its views in *Kimbrell's Home Furnish., Inc.* v. *Commissioner*, 7 T. C. 339, notwithstanding the reversal of that decision, 159 F. 2d 608 (C. A. 4), applied the Treasury Regulations. The Court of Appeals followed the Court of Appeals for the Fourth Circuit in *Kimbrell's* case in holding that the regulation was invalid.

1. As is pointed out in the petition for a writ of certiorari which is being filed in *Commissioner* v. *Basalt Rock Co.*, No. 803, and for reasons similar to those there developed, the decision of the court below is in conflict with the decisions of this Court holding that Treasury Regulations must control unless unreasonable and plainly inconsistent with the statute, and that Regulations such as this one which constitute a contemporaneous construction of the statute by its administrators should not be overruled except for weighty reasons. *Commissioner* v. *South Texas Co., supra; Commissioner* v.

Wheeler, 324 U. S. 542; *Helvering* v. *Wilshire Oil Co.,* 308 U. S. 90; *Fawcus Machine Co.* v. *United States,* 282 U. S. 375; *Brewster* v. *Gage,* 280 U. S. 327; *Boske* v. *Comingore,* 177 U. S. 459.

a. The Court of Appeals' rejection of the regulation is squarely based on the assumption—first expressed by the Fourth Circuit in the *Kimbrell* case, and not supported by the statutory language or the legislative history—that Congress in enacting Section 736(a) [3] not only permitted certain installment basis taxpayers to report *income* on an accrual basis for the purposes of the excess profits tax, as the language of the section plainly states, but also directed that they be permitted to compute earnings and profits (a subject which Section 736(a) does not even mention) on the accrual basis, for the purpose of calculating the excess profits tax credit —another subject to which the section does not refer. *Infra,* pp. 10-11, 21-23. The Tax Court in its well-reasoned *Kimbrell* opinion, 7 T. C. 339, found nothing in the statute or legislative materials to justify the conclusion that by Section 736(a) Congress intended broader relief than the Regulations granted. And in all subsequent cases involving this and related issues, the Tax Court, convinced of the correctness of its original views, has consistently adhered to them and refused to follow the

[3] This provision was added to the Internal Revenue Code by Section 222(d) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

Fourth Circuit.[4] The Court of Appeals for the Third Circuit, although concerned only with the narrower issue of uncollected installment profits from sales in pre-excess profits tax years (*i. e.*, pre-1940), recently interpreted Section 736(a) and its legislative materials in a manner quite inconsistent with the court below and the other Courts of Appeals reaching the same result. *May, Stern & Co.* v. *Commissioner,* C. A. 3, decided April 10, 1950. This disagreement between the Courts of Appeals for the Fourth, Second and Ninth Circuits on the one hand, and the Court of Appeals for the Third Circuit and a consistent Tax Court on the other hand, at the very least establishes that the statutory language is reasonably capable of being interpreted in diverse manners, and that the legislative materials are not decisive of which interpretation must be accepted. It fol-

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[4] *J. L. Goodman Furniture Co.* v. *Commissioner,* 11 T. C. 530; *Hart Furniture Co.* v. *Commissioner,* 12 T. C. 1103 (pending on appeal before the Court of Appeals for the Fifth Circuit); *House of Lindberg* v. *Commissioner,* decided October 25, 1948 (1948 P-H T. C. Memorandum Decisions, par. 48,207) (pending on appeal before the Court of Appeals for the Seventh Circuit); *Breuner Co.* v. *Commissioner,* decided May 12, 1948 (1948 P-H T. C. Memorandum Decisions, par. 48,078) reversed by C. A. 9, 179 F. 2d 685; *White Brothers Co.* v. *Commissioner,* decided August 11, 1948 (1948, P-H T. C. Memorandum Decisions, par. 48,154 (affirmed, 180 F. 2d 451 (C. A. 5)); *Sokol Brothers Furniture Co.* v. *Commissioner,* decided March 10, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,064) (pending on appeal before the Court of Appeals for the Fifth Circuit); *May, Stern & Co.* v. *Commissioner,* decided May 26, 1948 (1948 P-H T. C. Memorandum Decisions, par. 48,088), affirmed April 10, 1950 (C. A. 3).

lows, we submit, that in declaring the Regulations invalid, the court below was merely giving effect to what it considered a preferable view of the statute, in clear disregard of this Court's repeated admonitions concerning the weight to be accorded Treasury Regulations.

b. In fact, the vice of the decision below is much greater. Its view is inconsistent with the statute and the Congressional purpose in enacting Section 736(a). It is plain from the Committee Reports and the Congressional hearings that the only relief asked of Congress, or considered by it, was that of avoiding the effect of "bunching" of income (during the excess profits tax years) of concerns doing business on the installment basis, which might be caused by the impact of the war economy on their business. Hearings before House Ways and Means Committee on the Revenue Revision Bill of 1942, 77th Cong., 2d sess., pp. 1717, 1720-21; H. Rep. No. 2333, 77th Cong., 2d sess., p. 26 (1942-2 Cum. Bull. 372); S. Rep. No. 1631, 77th Cong., 2d sess., p. 207 (1942-2 Cum. Bull. 504); *May, Stern & Co.* v. *Commissioner,* C. A. 3, decided April 10, 1950, *supra; Kimbrell's Home Furnishings, Inc.* v. *Commissioner,* 7 T. C. 339, 345-346. The cited legislative materials show that the relief contemplated by Congress, in enacting Section 736(a), was to allow qualifying taxpayers to accelerate their income from installment sales

in order that selling expenses could reduce the excess profits net income over what it would be under the straight installment basis of reporting which would not properly take account of the war-caused contraction of installment sales, and also to exclude from the measure of the excess profits tax gains included in installments actually received during the excess profits tax years but attributable to sales made in earlier years. This, as the Tax Court pointed out in *Kimbrell's* case, *supra*, p. 346, benefits the taxpayer substantially. The further benefit which this taxpayer now seeks—a substantial enlargement of its earnings and profits—was never referred to by Congress in either Committee Reports or in the statutory language, and there is no reason to believe that it was intended.[5]

On the contrary, left unchanged by the addition of Section 736(a) were the provisions of Code

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[5] The court below, quoting from the Fourth Circuit, holds that the purpose of Section 736(a) was to place installment sellers on an equal footing, in all respects, with other taxpayers on an accrual basis, so far as the excess profits tax was concerned (R. 45); but the fact is that no such purpose is evident in the legislative history. The Third Circuit, in *May, Stern* v. *Commissioner*, decided April 10, 1950, declines to find the broad aim which the court below has discovered. See *supra*, pp. 9-10. Moreover, the status of a taxpayer on an ordinary accrual basis necessarily differs from that of a corporation electing to proceed under Section 736(a), since the former not only includes the uncollected profits contained in its accounts receivable in earnings and profits, but also reports these uncollected profits as income for income tax purposes. The ordinary accrual basis taxpayer thereby decreases its earnings and profits to the extent of its payment of the income tax.

Sections 115(l),[6] 718(a)(4),[7] (Appendix, *infra*, pp. 18-21) 728,[8] 718(a)(3), 718 (a)(6)(F), 718 (b)(1), (2) and (3).[9] These sections, when considered together, as they must be, show a specific statutory purpose generally[10] to use the term "accumulated earnings and profits", in the excess

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[6] This subsection was added to the Code by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974. It was expressly intended to control the excess profits meaning of "earnings and profits" as used in computing invested capital. H. Rep. No. 2894, 76th Cong., 3d sess., p. 41 (1940-2 Cum. Bull. 496, 526). See, also, Report of the Subcommittee of the Committee on Ways and Means, 76th Cong., 3d sess., on Proposed Excess-Profits Taxation and Special Amortization, p. 14. See, also, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 504-505.

[7] This subsection provides that accumulated earnings and profits are a component of equity invested capital. It was this section that Congress expressly had reference to in enacting Section 115(l). See note 6, *supra*.

[8] This section incorporates the Chapter 1 definition of earnings and profits, by reference, into the excess profits tax provisions. See *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 500, fn. 7.

[9] These subsections all deal with earnings and profits in their Chapter 1 dividend sense and are inconsistent and unworkable if it be assumed that Chapter 1 earnings and profits can be a sum different from excess profits tax earnings and profits. See, for example, H. Rep. No. 2894, 76th Cong., 3d sess., pp. 24-25 (1940-2 Cum. Bull. 496, 513) explaining Section 718(a)(3), *supra*, which provides for the inclusion in equity invested capital of "distributions in stock * * * to the extent which they are considered distributions of earnings and profits," where it is made plain that the statute is dealing with taxable stock dividends, a concept which could only have meaning in connection with its Chapter 1 sense, since only Chapter 1 and not the excess tax provisions deal with the taxability of dividends.

[10] Where Congress intended an exception to this general rule, it made express provision for a special computation of earnings and profits "for the purposes of this subchapter", *i.e.*, the excess profits tax. Section 718(c) (5). See also sections 718(a)(7), 718 (b)(5).

profits tax provisions, in its Chapter 1 sense as the fund out of which taxable dividends can be paid. See Treasury Regulations 112, Sec. 35.718-2. See, also, H. Rep. No. 2894, 76th Cong., 3d sess., p. 41. Yet the necessary consequence of the Court of Appeals' position is that once an election has been made under Section 736(a) there are two different earnings and profits, one under Chapter 1 and the other under the excess profits tax provisions.[11] This conclusion, which is expressly avoided by the Commissioner's Regulations, appears to be in conflict with the statutory plan of a unitary concept of earnings and profits.

In particular, the provision in Section 115(l) of Chapter 1 that gain from installment sales shall increase earnings and profits only to the extent that such gain "was recognized in computing net income under the law applicable to the year in which such sale or disposition was made" (*infra,* pp. 18-20; *supra,* p. 12, fn. 6) supports the correctness of the Commissioner's Regulation. The taxpayer's uncollected earnings and profits involved here have never been "recognized in computing net income" (*supra,* pp. 3, 5), and the statute does not

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[11] Indeed, under the decision of the Ninth Circuit in *Breuner Co.*, No. 805, there are three computations of earnings and profits. One is for Chapter 1 purposes and two are for excess profits tax purposes, depending on whether the sales were made before or after the effective date of the excess profits tax law. See, also, *White Brothers Co.* v. *Commissioner, supra,* fn. 4.

say, as the court below would in effect refashion it, that recognition in computing "excess profits net income" is sufficient. In *May, Stern & Co.* v. *Commissioner,* decided April 10, 1950, the Third Circuit, while understandably disclaiming any opinion as to the precise question presented here, appeared to doubt that Section 115(l) can be read in this expansive way, and characterized the "liberal" decision below as representing "the limit beyond which it is impossible to go. . ." [12]

c. The taxpayer argued in the court below that the Commissioner's position in *Basalt Rock Company, Inc., supra,* No. 803, that the election permitted by Section 736(b) to compute "income" under the percentage-of-completion method of accounting was for all purposes of computing income subject to the excess profits tax, is inconsistent with the Commissioner's position in this case. Superficially, certain underlying arguments advanced by the Commissioner in support of his Regulations in the *Basalt Rock Company, Inc.,* case, on the one hand, and in the present case and the *Breuner Co.* case, *supra,* No. 805, on the other, may appear to be inconsistent. Actually, however, the Commissioner's Regulations applicable to the *Basalt Rock Company* question and the Commissioner's Regulations applicable to the question in the present case and in *Breuner* are

[12] As we note above, the *May, Stern* opinion also conflicts with the decision below in its interpretation of the Congressional purpose in enacting Section 736(a). See *supra,* pp. 9, 10, 11.

entirely consistent when the entire statutory plan and the legislative history of the several sections are properly appraised. The Commissioner believes, therefore, that his Regulations in both cases must be sustained, but it would appear clear that to the extent the taxpayer's charge of inconsistency may have validity, the courts themselves have been unwarranted and inconsistent in striking down *both* Regulations.

2. The general complexity of the excess profits provisions is already well known to the Court. The particular complexity of the instant problem, involving as it does a dual system of accounting and the interrelation of one kind of a tax based on one system of accounting to a second tax based on another system, needs no documentation. The meticulousness with which Congress has dealt with "earnings and profits" in the various subsections of 718 cited *supra*, p. 12, before Section 736(a) was ever added to the Code, makes it extremely doubtful that it was intended that this precise statutory structure was required to be changed in so much of its express coverage by a section that nowhere speaks of the excess profits tax credit—to say nothing of accumulated earnings and profits. It is much more reasonable to assume that Congress intended that these technical problems, complex and numerous, were to be left to the Commissioner's Regulations. Indeed, Congress ensured that the ramifications of an election under Section

736(a) were to be treated administratively when it provided that the election should be exercised in accordance with Regulations to be promulgated by the Commissioner. These Regulations more than the usual ones are especially entitled to the greatest respect. See *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90. See also *Commissioner* v. *South Texas Co., supra; Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 305; *Avent* v. *United States*, 266 U. S. 127; *United States* v. *Grimaud*, 220 U. S. 506.[13] Moreover, the content of earnings and profits is historically a creature of Treasury Regulations. *Commissioner* v. *Wheeler*, 324 U. S. 542. Since the Commissioner had authority to define the concept under his general regulatory authority, as this Court held in *Wheeler*, he must *a fortiori* be within his authority where, as in Section 736(a), he is specifically directed to treat in Regulations the conditions, and the consequences, of the election provided by that section.

3. The decision below raises a question of substantial importance in the administration of the revenue. In addition to this case and *Commissioner* v. *Breuner Co.*, No. 805, there are approximately one hundred known pending cases, at various stages of the administrative and the judicial process, presenting issues relating to the computation of earnings and profits, for the purposes

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[13] See the petition for a writ of certiorari in *Commissioner* v. *Basalt Rock Co.*, No. 803, pp. 12-14.

of the excess profits tax credit, after an election under Section 736(a).[14] Large amounts of revenue are involved. In view of the large number of cases extant, further litigation with a view to securing a clear-cut Court of Appeals' recognition of the Regulation's validity would at best only postpone consideration of the issue by this Court. In the light of the history of the problem in the courts to date, such litigation could hardly be expected to make the question riper for later decision, but on the contrary would create unnecessary expense and uncertainty to taxpayers and the Government alike.

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

MAY 1950.

[14] There are eleven cases pending in District Courts, the Court of Claims, and the Courts of Appeals alone.

APPENDIX

Internal Revenue Code:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

(26 U.S.C. 1946 ed., Sec. 44.)

SEC. 115 [as amended by Section 501 (a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004, and as amended by Section 146 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 841]. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the

adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which

the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

CHAPTER 2—ADDITIONAL INCOME TAXES

* * * * *

SUBCHAPTER B [as amended by Section 506 (a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—DECLARED VALUE EXCESS-PROFITS TAX.

* * * * *

SEC. 718 [As added by Section 201, Second Revenue Act of 1940, *supra*, and amended by Section 203 of the Revenue Act of 1941, 55 Stat. 687]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and

shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U.S.C. 1946 ed., Sec. 718.)

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or

if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the tax-

payer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

(b) *Election on Long-Term Contracts.*—

* * *

(c) *Adjustment on Account of Change.*—If an adjustment specified in subsection (a) or subsection (b), as the case may be, is, with respect to any taxable year, prevented, on the date of the election by the taxpayer under subsection (a) or subsection (b), as the case may be, or within two years from such date, by any provision or rule of law (other than this section and other than section 3761, relating to compromises), such adjustment shall nevertheless be made if in respect of the taxable year for which adjustment is sought a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within two years after the date such election is made. * * *

(26 U.S.C. 1940 ed., Sec. 736.)

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.736 (a)-2. *Election to Compute Excess Profits Income on Straight Accrual Basis.*—If a taxpayer computing income from

installment sales under the method provided by section 44 (a) establishes eligibility for relief in accordance with the provisions of section 736 (a) and section 35.736 (a)-1, it may elect in its excess profits tax return for such year to compute income attributable to installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a), pursuant to which income for any taxable year is determined to be that proportion of the installment payments actually received during the year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

If the taxpayer elects under the provisions of section 736 (a) and this section to compute its income from installment sales on the straight accrual basis, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years and the income from installment sales for each taxable year before the first year with respect to which the election is made, but beginning after December 31, 1939, shall be adjusted for the purposes of the excess profits tax computation to conform to such election. Since no change in the computation of income from the installment basis to the straight accrual basis can be made for any year beginning prior to January 1, 1940, as a result of such election, no recomputation can be made for any year in the base period. If the taxpayer uses the

excess profits credit based on income pursuant to section 713 or section 742, the average base period net income shall be the actual average base period net income with income from installment sales computed under the method pursuant to which such income was reported for the purposes of the income tax under Chapter 1 for the taxable years in such period. If the taxpayer uses the excess profits credit based on invested capital pursuant to section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736 (a) and this section, except as such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939. The election made pursuant to section 736 (a) and this section to compute income on the straight accrual basis in lieu of the basis provided in section 44 (a) shall apply only with respect to excess profits net income for purposes of the excess profits tax imposed by Subchapter E of Chapter 2. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income shall be computed upon the basis provided in section 44 (a).

* * * * *

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No. 804

IN THE

Supreme Court of the United States

OCTOBER TERM, 1949

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

BUSCH'S KREDIT JEWELRY CO., INC.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

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BUSCH'S KREDIT JEWELRY CO., INC.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below.

The opinion of the Tax Court (R. 35) is reported at 7 T. C. M. 977. The opinion of the Court below (R. 43 A to 46) is reported at 179 F. 2d. 298.

Jurisdiction.

The Judgment of the Court of Appeals was entered on January 6, 1950. By order of Mr. Justice Jackson, dated

March 24, 1950, the time for filing a Petition for a Writ of Certiorari was extended to and including May 7, 1950. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254.

Question Presented.

Whether a taxpayer, who has elected to compute its excess profits tax liability on the accrual basis pursuant to the option in Internal Revenue Code, Section 736 (a) in lieu of the installment sales basis as provided in Internal Revenue Code, Section 44 (a), which basis the taxpayer uses in computing its normal and surtax liability, may include in accumulated earnings and profits the uncollected profits on installment sales on which tax has been paid for excess profits tax purposes as a part of equity invested capital for excess profits tax purposes under the provisions of Internal Revenue Code Section 718 (a) (4).

Statutes and Regulations Involved.

The applicable statutes and regulations are printed in the appendix *infra* pages 11-19

Statement.

This case involves a deficiency in excess profits taxes for the year 1944 and a deficiency in income tax for the year 1945.

The taxpayer is a New York corporation engaged in the retail sale of jewelry and related merchandise. Virtually all of its sales are on the installment credit plan. It computed its net income for income tax purposes on the installment sales basis under Section 44 (a) of the Internal Revenue Code. That sub-division permits a taxpayer who

regularly sells personal property on the installment plan to "return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profits realized or to be realized when the contract is completed bears to the total price."

With respect to its excess profits tax liability, Petitioner elected to avail itself of the option provided in Section 736 (a) of the Internal Revenue Code, to compute its income from installment sales on the accrual basis rather than on the installment basis. Such option was made available to taxpayers who had previously reported their income for both income and excess profits tax purposes on the installment basis. Section 736 (a) contains, *inter alia:*

> "*Election to accrue income*—In the case of any taxpayer computing income from installment sales under the method provided by Section 44 (a) * * * it may elect * * * for the purpose of the tax * * * to compute in accordance with regulations prescribed by the Commissioner with approval of the Secretary its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by Section 44 (a) * * *"

The taxpayer computed its excess profits tax liability on the invested capital method as provided by Sections 712, 714, 715, 716, 717 and 718 of the Internal Revenue Code. The invested capital method provides for a credit of 8% of invested capital as a credit against excess profits tax net income. Invested capital as defined in the Internal Revenue Code includes equity invested capital and borrowed invested capital. Equity invested capital includes *inter alia* the taxpayer's accumulated earnings and profits as of the beginning of the year. Taxpayer claimed that the accrued profits on its installment sales made after December 31, 1939, on which it paid excess profits tax, were a part of its accumulated earnings and profits includible in

its invested capital, upon which the 8% credit should be computed. The Commissioner however held that the 8% could only be computed upon the collected portion of the installment sales as taxed under the provisions of Section 44 (a) for income tax purposes. The Commissioner's position is set forth in Treasury Regulations 112, Section 35.736 (a)—2, which provides in part:

> "If the taxpayer elected under the provisions of 736 (a) * * * to compute its income from installment sales on a straight accrual basis, such election shall be irrevocable * * * if the taxpayer uses the excess profits credits based on invested capital pursuant to Section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from the election made under Section 736 (a) and this section, except as such election is reflected in the amount of income tax or excess profits tax payable for the taxable years beginning * * *"

Based upon such Regulation, the Commissioner of Internal Revenue refused to permit the taxpayer to include in its accumulated earnings and profits uncollected profits on installment sales made after December 31, 1939, which uncollected profits had been taxed for excess profits tax purposes, and determined the tax deficiencies which are presently in issue.

The Tax Court in a memorandum opinion dated March 15, 1949, upheld the Commissioner's determination. Upon appeal to the Court of Appeals for the Second Circuit, that Court reversed the Tax Court.

Summary of Argument.

The judgment of the Court of Appeals for the Second Circuit is correct and is not in conflict with the decision of any other Court of Appeals of any other circuit. The judgment of the lower Court is not in conflict with any

decision of this Court. Finally, the present case is not of general tax importance, because the applicable statutory provision has limited application and after being in existence for a relatively short time, has been repealed.

Argument.

1. The question involved in the present case has been the subject of litigation in the Fourth, Second and Ninth Circuits and in each instance the Courts of Appeal have reversed the Tax Court and have rejected the Commissioner's determination. The decided cases in the circuits are as follows: *Kimbrell's Home Furnishings, Inc. v. Commissioner of Internal Revenue,* 159 Fed. 2nd, 608, which was decided by the Court of Appeals for the Fourth Circuit; the case of *John Breuner Co. v. Commissioner of Internal Revenue,* — Fed. 2nd —, 50-1 USTC 5948, which was decided by the Court of Appeals for the Ninth Circuit and the present case. In each instance, the Courts of Appeal for said circuits have struck down the Regulations as promulgated by the Commissioner. The United States District Court for the District of Massachusetts, in the case of *Hadley Furniture Co. v. U. S.,* 87 Fed. Supplement 590 also decided the issue in the same manner as the foregoing Courts of Appeals. To date there is no conflict between the Courts of Appeal.

The Court of Appeals for the Third Circuit recently decided the case of *May-Stern & Co. v. Commissioner* on April 10, 1950, but that case was concerned only with the issue of uncollected installment profits from sales in years prior to the excess profits tax years and which uncollected installment profits had not been subjected to the excess profits tax. In that case the Court said that they did not express judgment on the decision of the Second Circuit in the present case inasmuch as the present case did not deal with the problem of the *May-Stern* case.

2. The lower Court in the present case said in reference to the Regulations, that the Regulations were struck down because if they were applied to the facts before us, the Regulations would fly in the face of a natural and reasonable meaning of Section 736 (a) of the Code.

The Commissioner argues in his brief, page 7, that the decision of the Court below is in conflict with the decisions of this Court, which hold that Treasury Regulations must control unless unreasonable and plainly inconsistent with the statute and that Regulations such as this one constitute a contemporaneous construction of the statute by its administrators which should not be over-ruled except for weighty reasons. *Commissioner v. South Texas Co.*, 333 U. S. 496.

In answer to that it is no novelty for Regulations issued under Section 736 (a) to be declared invalid and for the Commissioner to acquiesce in such determination. See *Commissioner v. Hecht Company*, 163 F. (2d) 194 and *Commissioner v. Mackin Corporation*, 164 F. (2d) 527, Asquiesced in at 1948—2 CB 2, 3. In those cases the Regulations provided that the taxpayer could not deduct bad debts arising from goods sold in years prior to the excess profits tax years after it had elected to compute its excess profits tax liability on the accrual basis under Section 736 (a). It was held that the regulations were illogical and inequitable and contrary to general principles of Federal Tax Law, and further, that if Congress, in view of its long experience in tax legislation had intended results contrary to general principles of Federal Tax Law, it would certainly have said so and not have left important matters to vague inference.

The Commissioner in his brief on page 8, states that the lower Court's decision is not supported by statutory

language or legislative history. In answer to that, it is agreed that there is no statutory language which clearly disposes of the present case. Therefore there arose the present controversy over the unreasonableness and inequity of the Commissioner's Regulations. The Taxpayer differs with the Commissioner's conclusion as to legislative history, and believes that the spirit of the statute can readily be found in a reading of the hearings before the *House Ways and Means Committee on the Revenue Revision Bill of 1942, Seventy-seventh Congress, Second Session,* Pages 1720, 1721 and 1725, which provide that the reason for Section 736 (a) was to give relief to installment sales taxpayers and to place them on an equal competitive basis as far as the excess profits tax results were concerned with taxpayers who reported on the accrual basis. *House of Representatives Report No. 2333, 77th Congress, First Session,* page 26; 1942-2 C. B. 394, clearly indicates that Section 736 (a) is a relief section and passed for remedial purposes. Relief statutes are to be liberally construed in the taxpayer's favor. *Bonwit, Teller and Co. v. U. S.,* 283 U. S. 258.

The Commissioner states that the Tax Court has consistently found nothing in the statute or legislative materials to indicate that Congress intended more relief than the Regulations granted. The Tax Court erroneously has refused to recognize the unreasonableness and inconsistency of the Regulations, when compared with the original purpose of Section 736 (a). The Circuit Court of Appeals for the Fourth Circuit in *Kimbrell's Home Furnishings, Inc. v. Commissioner* stated concerning the purpose of Section 736 (a), "It is clear that the purpose of the statute was to place installment sellers on an equal footing with other taxpayers on an accrual basis so far as the determination of the excess profits tax is concerned."

The Commissioner in his brief, on pages 11 and 12, concludes that the term "accumulated earnings and profits" must be interpreted in the "income tax sense" for the reason that certain of the Internal Revenue Code Sections were left unchanged, when Section 736 (a) was passed and that these sections show a specific statutory purpose. The taxpayers answer to that is that the basic principal of computing earnings and profits is clearly set out in *Regulations 111, Section 29.115-3,* which requires consistency between the method used in computing "net income" and the method used in computing "earnings and profits". This Court in the South Texas case recognized and applied the doctrine of consistency. A review of the applicable sections of the Internal Revenue Code, i. e. Section 21, Section 13 (a)-1, Section 13 (a)-2, Section 710 (a)-1, Section 710 (b) and Section 711 (a), all indicate that both "net income" and "excess profits tax net income" are merely resultant amounts of "net income." Furthermore, it would appear that the "excess profits tax" is actually an income tax. Page 20 of the Commissioner's Brief shows the following heading "Chapter 2—Additional Income Taxes". "Sub-Chapter E—Excess Profits Tax" is a division of Chapter 2. That would seem to indicate that the excess profits tax is also an income tax. This concept is borne out by the following observation found in *Volume 7 (A), Merton's Law of Federal Income Taxation, Paragraph 42.01, at page 10,* where the author speaks of the nature of the excess profits tax and states "it is substantially but a vehicle for imposing a higher income tax on earnings and profits". It then follows that the requirement of consistency as set forth in the *South Texas* case and in Regulations Section 29.115-3 requires that "accumulated earnings and profits" whether they be computed for either the corporation's normal and surtax liability or its

excess profits tax liability, must be determined from the accounting basis upon which "net income" is determined. In this case "net income" was determined on the accrual basis and to be consistent, "earnings and profits" must be determined on the same accounting basis.

The Commissioner argues that the lower Court by its decision permits two different amounts of earnings and profits and that such a result conflicts with what the Commissioner believes to be a unitary concept of earnings and profits. The Commissioner conveniently ignores the permission given to the Petitioner by the provisions of Section 736 (a) to employ the accrual basis of accounting for excess profits tax purposes and thereby determine two amounts of "net income" i. e. one for excess profits purposes and one for normal and surtax purposes. The Commissioner conveniently forgets that this case is principally an excess profits tax case and not an income tax case and that the emphasis should be on determining what is the correct amount of the Petitioner's excess profits tax liability. The Commissioner further refuses to recognize and give due weight to the fact that the uncollected gross profits on installment sales have gone through the Petitioner's income account and excess profits taxes have been paid thereon. It would further appear that there is no necessity that accumulated earnings and profits be identical for income tax purposes and excess profits tax purposes, so long as accumulated earnings and profits for any tax purpose include profits which have been taxed for any purpose.

3. Sub-Chapter E of Chapter 2 of the Internal Revenue Code was repealed for taxable years beginning after December 31, 1945 by *Section 122 (a) of the Revenue Act of 1945.* Section 736 (a) a part of Sub-Chapter E of Chapter

2 of the Internal Revenue Code therefore had been operative for the relatively short period of the excess profits tax years starting after December 31, 1939 and ending on December 31, 1945. It would appear that a section of a statute which had been in existence for such a short period of time could hardly present a case of general tax importance. At best, the Commissioner in his Brief, on page 16, knows of only 100 pending cases. Inasmuch as the excess profits tax has been repealed since 1945, the question cannot be recurring. Any problems which have arisen have arisen in the past and it would appear that the writ should be denied until such time as there is a definite conflict between the Courts of Appeals for the various circuits, whereby at least one Court of Appeals definitely and unqualifiedly recognizes the Commissioner's position as set forth in the Regulations.

Conclusion.

The Petition for writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX.

STATUTE AND REGULATIONS

INTERNAL REVENUE CODE

Sec. 44 INSTALLMENT BASIS

(a) DEALERS IN PERSONAL PROPERTY.—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(d) GAIN OR LOSS UPON DISPOSITION OF INSTALLMENT OBLIGATIONS.—If any installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the fact value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. If an installment obligation is distributed by one corporation to another corporation

in the course of a liquidation, and under Section 112 (b) (6) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation, then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation.

Sec. 115 Distributions by Corporations

(1) Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purpose of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to

the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

Sec. 718 EQUITY INVESTED CAPITAL

(a) DEFINITION.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts reduced as provided in subsection (b)—

(4) EARNINGS AND PROFITS AT BEGINNING OF YEAR.—The accumulated earnings and profits as of the beginning of such taxable year.

Sec. 736 RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) ELECTION TO ACCRUE INCOME.—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a) if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the

income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made out beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

REGULATION 111

Sec. 29.44-1 SALE OF PERSONAL PROPERTY ON INSTALLMENT PLAN.—Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the installment plan. * * *

The general rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of

the installment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for, bears to the total contract price. Thus, the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. * * * Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued," as provided by Sections 43 and 48. * * *

Sec. 29.115-3 EARNINGS OR PROFITS.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913 or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under Sections 41, 42 and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in Section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under Section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of Section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the

Federal Government under the Constitution, as well as all items includible in gross income under Section 22 (a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of Section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see Section 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (1) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost of March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery of percentage depletion under all Revenue Acts for mines and oil or gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation. * * *

Sec. 29.115-12 Effect on Earnings and Profits of Gain or Loss Realized After February 18, 1913.—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, Section 115 (1) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corpo-

ration for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of Chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. • • •

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see Section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of Section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of Section 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under Section 113 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of Section 115 (1) as distinguished from the realized gain or loss used in computing net income. • • •

REGULATION 112

Sec. 35.718-2 DETERMINATION OF DAILY EQUITY INVESTED CAPITAL—ACCUMULATED EARNINGS AND PROFITS.—(a) *In general.* The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, Section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and Section 35.718-5 as to the effect of the declaration and

distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. As to determination of additional amount to be included in daily equity invested capital on account of new capital, see Section 35.718-4. In computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accural basis shall subtract the income and excess profits taxes for the preceding taxable year. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit. Unrealized appreciation in value of property is not a factor in determining earnings and profits. • • •

If the transaction which resulted in the transfer to the taxpayer of the earnings and profits of another corporation constitutes an intercorporate liquidation subject to the provisions of Section 761, the rule of the preceding paragraph shall apply only with respect to that portion of such earnings and profits attributable to the stock of such other corporation held by the taxpayer with a basis determined under Section 761 to be a basis other than cost. Section 761 (d) (1) provides for the adjustment appropriate with respect to the earnings and profits of such other corporation taken over in the liquidation attributable to the stock of such other corporation held by the taxpayer with a basis determined to be a cost basis. • • •

Sec. 35.736 (a)—2 Election to Compute Excess Profits Income on Straight Accrual Basis.—If a taxpayer computing income from installment sales under the method provided by Section 44 (a) established eligibility for relief in accordance with the provisions of Section 736 (a) and Section 35.736 (a)—1, it may elect in its excess profits tax return for such year to compute income attributable to installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by Section 44 (a), pursuant to which income for any taxable year is determined to be that proportion of the installment

payments actually received during the year which the gross profit realized or to be realized when payment is completed, bears to the total contract price. * * *

(d) Amended income and excess profits tax returns for each taxable year beginning after December 31, 1939, and prior to the taxable year for which the election is made, to reflect the effects of the computation of income from installment sales for the purposes of the excess profits tax for such years on the basis of the taxable period for which such income is accrued. If the recomputation produces an over-assessment for any of such years, the taxpayer should file a claim for refund on Form 843 with the amended returns for such years. * * *

If the taxpayer elects under the provisions of Section 736 (a) and this section to compute its income from installment sales on the straight accrual basis, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years and the income from installment sales for each taxable year before the first year with respect to which the election is made, but beginning after December 31, 1939, shall be adjusted for the purposes of the excess profits tax computation to conform to such election. Since no change in the computation of income from the installment basis to the straight accrual basis can be made for any year beginning prior to January 1, 1940, as a result of such election, no recomputation can be made for any year in the base period. * * * If the taxpayer uses the excess profits credit bases on invested capital pursuant to Section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under Section 736 (a) and this section, except as such election, is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939. The election made pursuant to Section 736 (a) and this section to compute income on the straight accrual basis in lieu of the basis provided in Section 44 (a) shall apply only with respect to excess profits net income for purposes of excess profits tax imposed by Subchapter E. of Chapter 2. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income shall be computed upon the basis provided in Section 44 (a). * * *